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Summary
¶1. (U) Despite muted warnings over the last few months, the European Commission (EC) for Economic and Monetary Affairs Joaquin Almunia recently gave Portugal passing marks for its efforts to reduce its huge budget deficit and undertake structural reforms, in accordance with Growth and Stability Pact commitments. Bank of Portugal Governor Vitor Constancio, who has been critical of the government in the past, also expressed support for the government's efforts but cautioned against end of the year spending which threatened to undercut gains made earlier in the year. On the other hand, the OECD expressed concern in its April report by lowering key economic indicators for Portugal and recommended that the government take additional measures in order to reach its target of reducing the budget deficit to 4.6% of GDP in 2006. End Summary

Overview
¶2. (U) In 2005, the newly elected Socialist government of Jose Socrates undertook a series of measures (reftel) to rein in Portugal's soaring deficit which was well on its way towards reaching 6.8% of GDP and to counter the loss of purchase power parity vis-a-vis the EU-25 average. Its revised 2005 budget did not resort to extraordinary measures. Instead it raised value-added tax rates, thereby greatly increasing revenue and preventing the deficit from growing beyond 6%. It also introduced a multi-year Technology Plan that targets education, human capital, research and development, and public-private in an effort to make Portugal more competitive and attractive to foreign investment. The economy stagnated, however, as GDP grew by a mere 0.3%.

¶3. (U) The 2006 consolidated national budget aims to reduce the government deficit by 1.4% to 4.6% of GDP. It has raised taxes on gasoline and tobacco, undertaken social security reforms by increasing contributions, raising the civil service retirement age, and reducing pension outlays to retirees. It has also begun to restructure its civil service by downsizing several ministries and reducing their budgets, cutting health expenditures and creating an interagency oversight system to monitor investments over 250 million euros. Perhaps most importantly, it has made major improvements in its public finance statistical reporting and created a technically independent commission to monitor the deficit, a move which helped to remove the EC's lingering doubts about the government's willingness and ability to implement the needed reforms.

¶4. (U) In 2007, Portugal hopes to reduce its budget deficit by 0.9% to 3.7% of GDP by further increasing taxes on

gasoline and tobacco, consolidating expenditure cutbacks resulting from 2006 reforms in health, pensions and public administration, and implementing a new civil service structure, to include civil service mobility and sliding salaries. The 2008 Growth and Stability target brings Portugal in line with the "no greater than 3% budget deficit" Eurozone policy by decreasing it 1.1% to 2.6% of GDP.

Growth Predictions

¶5. (U) Given all the measures outlined above, the government maintains that it is on track to reach its Growth and Stability Pact goals - predicting a 1.1% increase in GDP in 2006, a 1.8% increase in 2007, and a convergence with the EU-25 median of 2.1% by 2010. The European Commission's prediction is slightly less optimistic, at 0.9% in 2006 and 1.1% in 2007, due to lingering concerns with the government's efforts to control spending - namely social transfers, regional/autonomous zone transfers to the central government, and late payments collection. On the positive side, the EC has removed its reservations regarding the nation's statistical methodology and collection. The Bank of Portugal has indicated it will raise its 2006 estimate of 0.8% GDP growth and 2007 estimate 1.0% due to increases in private investment and exports, but has not yet done so.

¶6. (U) However, the OECD has downgraded GDP growth to 0.7% in 2006 because it believes Portugal must undertake additional measures to reach its targets and doubts the government's optimism with regard to efficacy of its budget consolidation measures. In response to the OECD's April report, Finance Minister Fernando Teixeira dos Santos commented that Portugal would undertake additional measures if necessary. Though the public has, by and large, been very supportive of the government's belt tightening measures, there was rumbling at the mention of further measures.

Projected GDP (% change from previous year)

	2006	2007
Government	1.1	1.8
European Commission	0.9	1.1
OECD	0.7	1.5
Bank of Portugal	0.8	1.0

Deficit Reduction

¶7. (U) With specific regard to the budget goals outlined under the Growth and Stability Pact, the government remains committed to reducing its deficit to 4.6% in 2006 and 3.7% in 2007, noting improvement in revenue collection. Both the OECD and the European Commission predict that the budget deficit will reach 5.0% in 2006, with the former underscoring the need to strengthen consolidation efforts, increase taxes, control expenses, intensify reforms in social security and public administration, strengthen manufacturing specialization, and enhance education and personnel resources, and the latter expressing concern with the increase in social transfers and huge debt payments.

¶8. (U) The EC predicts a budget deficit of 4.9% in 2007 in contrast to the government's estimate of 3.7% because the government has not yet introduced legislation to control public expenditures although it announced its attention to do so over a year ago and because it predicts GDP growth of only 1.1% instead of Portugal's more optimistic estimate of 1.8%.

Budget Deficit Projections (% of GDP)

	2006	2007	2008
Government	4.6	3.7	2.6
European Commission	5.0	4.9	n/a
OECD	5.0	n/a	n/a
Bank of Portugal	n/a	n/a	n/a

Unemployment Trends

¶9. (U) With regard to unemployment, though the rate increased to 8.0% this year for the first time since the 1980s, the

government predicts unemployment will stabilize around 7.7% in 2006 and drop to 7.5 % in 2007 due to salary adjustments. The OECD also predicts that unemployment will decrease in 2007 to 7.7% due to relatively better economic conditions, but that real salaries will grow faster than productivity. EC predictions contrast with those of the government and the OECD, estimating that unemployment will reach 8.1% in 2006 and 8.3% in 2007, with job creation being sluggish.

Unemployment (% of eligible workforce)

	2006	2007
Government	7.7	7.5
European Commission	8.1	8.3
OECD	7.7	7.6
Bank of Portugal	n/a	n/a

Current Account Balance

¶10. (U) As for the current account balance, the price of oil has further exacerbated the current account deficit, with the government predicting a deficit increase of 8.8% in 2006 and 8.4% in 2007 due to a slight recovery in the balance of goods and services. The Bank of Portugal predicts a current account deficit of 8.5% in 2006 and 8.8% in 2007. Painting an even more pessimistic picture, the OECD predicts external debt will reach 9.6% of GDP in 2006, and the EC predicts it will reach 9.8% in 2006 and 9.6% in 2007 as oil costs continue to rise.

Current Account Deficit (% increase over previous year)

	2006	2007
Government	8.8	8.4
European Commission	9.8	9.6
OECD	9.6	n/a
Bank of Portugal	8.5	8.8

Export Growth

¶11. (U) And finally, with regard to export growth, Portugal's government predicts exports will increase by 5.7% in 2006 and 6.1% in 2007, but notes that the country will continue to lose its competitive edge if the government does not take corrective action. The Bank of Portugal and the OECD estimate that exports will grow by only 4% in 2006, again emphasizing the loss of competitiveness to Asia and the new EU members. The EC predicts that exports will grow by 3.9% and 4.5% in 2007, underscoring that the position of industrial goods will continue to deteriorate vis-a-vis emerging markets.

Export Growth (% change over previous year)

	2006	2007
Government	5.7	6.1
European Commission	3.9	4.5
OECD	4.0	n/a
Bank of Portugal	4.0	n/a

Comment

¶12. (SBU) The OECD's skeptical review provided a much needed reality check to an overly optimistic government. Though Finance Minister Teixeira dos Santos continues to paint a best case scenario for Portugal's economic recovery, it is likely that Portugal will have to undertake additional measures to meet its targets as outlined under the Growth and Stability Pact. Some have suggested that the government might reluctantly resort to one-off measures such as selling vacant government property. Other suggest that the government decrease rather than increase taxes to stimulate the economy, something Teixeira dos Santos has said he would not consider until the economy is much stronger. Still, post believes that the economy has turned the corner and that the government is on the right track, using its unprecedented four year term to ensure that reforms take root. Despite the economy's upward trajectory, there is much concern that Portugal will continue to lose ground to Eastern Europe, given that it will take decades for the Technological Plan -

with its focus on educational and personnel reforms - to take effect. Some have even theorized that the lack of confidence most Portuguese currently have in their economy is linked to the country's early 2002 World Cup defeat and the resulting pessimism. Perhaps Portugal's achievements in the 2006 World Cup will put the country back on the map literally - earning it new found respect both inside and out - and giving it the missing "can-do" optimism so sorely lacking in the nation's psyche.

Hoffman